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Senator McConnell's Proposed "Middle-Class Stimulus" Is Neither Middle-Class Nor Stimulative

Senate Minority Leader Mitch McConnell (R-KY) has recently said that he does not believe that the stimulus proposal put forward by President-elect Barack Obama is sufficiently focused on tax cuts. While Obama's proposal reportedly does include as much as \$300 billion in tax cuts, Senator McConnell argues that we need even more tax cuts, in particular for what he calls "the middle class." In pursuit of this alleged goal, McConnell proposes temporarily cutting the 25 percent income tax rate to 15 percent. There are at least three severe problems with this plan:

- By any reasonable measure, McConnell's proposed tax cut is not targeted to middle-income people. Instead, three-quarters of the tax cut would go to the best-off fifth of all taxpayers.
- It is very likely that McConnell will initially try to cover up the true cost of his proposal, and then later insist that Congress spend vastly more money because his tax cut would otherwise expand the Alternative Minimum Tax (AMT).
- The McConnell plan would function poorly as an economic stimulus.

1. Cutting the 25 percent tax rate to 15 percent will primarily benefit the well-off

Currently, the federal income tax has six regular tax brackets (plus a hodgepodge of special tax rates for capital gains and dividends). For a couple with two children, the rates start at zero on the first \$26,000 in income.¹ The next \$16,700 in taxable income is taxed at 10%, the next \$51,200 in taxable income is taxed at 15%, followed by the 25%, 28%, 33% and 35% brackets. The top rate doesn't kick in until total reported income exceeds about \$425,000. (Tax credits are then allowed to reduce income taxes actually owed.)

To reach the 25 percent tax bracket on any part of its income, a family of four will typically have to earn more than \$100,000 in 2009. (The 25 percent bracket starts at proportionately lower income levels for single people, reflecting the fact that couples have two taxpayers.) That's considerably more than most people earn. **In fact, only one in five of all taxpayers pays the 25 percent tax rate on any of his or her income.**²

Even for most people affected by the 25 percent tax bracket, the effects are small. **On average, for taxpayers whose top bracket is 25 percent, only 12.5 percent of their total income is taxed at 25 percent.** The rest is taxed at the lower rates of 0%, 10% and 15%.

¹Couples with two children get four personal exemptions of \$3,650 each, for a total of \$14,600, plus a "standard deduction" of \$11,400. Thus the first \$26,000 in reported income is not taxed. Better-off taxpayers can substitute itemized deductions for the standard deduction if their itemized deductions are bigger.

²The percentage of tax filers who pay tax on any of their income at the 25 percent rate varies by family status. In 2006, the IRS reports that the 25 percent rate affected 29% of married filers, 19% of childless single filers, and 6% of single-parent filers.

In fact, only taxpayers whose top bracket is greater than 25 percent can get the maximum benefit of cutting the 25 percent rate. That means that the maximum benefit of McConnell's tax cut is generally limited to couples making more than about \$185,000.³

A proposed tax cut that only benefits a fifth of all taxpayers, most of them well-off, and offers its biggest potential benefits to the wealthiest subset of that group, cannot be fairly called a "middle-class" tax cut.

Which should bring us to the distributional effects of McConnell's proposal. But before we get there, we need to examine a critical issue involving the Alternative Minimum Tax, or AMT.

2. Fun with numbers: use the AMT to reduce cost projections, then say you need to eliminate the AMT's "unintended" effects

Compared to current law, Senator McConnell's proposal would increase the deficit by a mere \$13.3 billion in 2009. This comparison to current law is the sort of projection congressional budget forecasters would likely make about the cost of McConnell's proposal, and it's one that McConnell is likely to cite. But it's fundamentally wrong.

Here's the problem: Under current law, in 2009 the alternative minimum tax (AMT) is scheduled to expand its reach to vastly more taxpayers than it affects today. We project that, unless the law is changed, the AMT will expand from reaching just 4 million taxpayers in 2008 to 26.8 million in 2009. Under McConnell's proposal, the AMT problem would get even worse.

Because the AMT is an alternative tax that is paid by better-off people if it is higher than their regular tax, cutting the regular tax on better-off people will push more of them into the AMT. In fact, if Congress enacted McConnell's proposal but left the AMT unchanged, the number of taxpayers affected by the AMT would jump to 31 million.

On paper, this expanded AMT would take back almost all (83%) of the \$77 billion tax cut in the regular income tax that people would otherwise get from McConnell's proposal. On the other hand, *there is absolutely no way that Congress will let this happen.*

The AMT has been in need of permanent adjustment for some time to prevent it from affecting taxpayers who are not as rich as the group originally targeted by it. Due to cost constraints, Congress has failed to enact a permanent adjustment to the AMT, but it has passed temporary adjustments every year or so to prevent the AMT from expanding. No member of Congress is willing to face the wrath of millions of constituents who must pay a seemingly arcane tax for the first time.

If the AMT is not allowed to expand and "take back" a lot of the tax cut proposed by McConnell, that means that McConnell's tax cut would cost far more. We estimate that if Congress provides the same sort of "patch" to the AMT that it has enacted for the past several years, then McConnell's proposal would cost \$45.1 billion a year — more than triple the cost if the almost certain AMT patch is ignored.⁴

And that's not all. Even with a traditional AMT patch, McConnell's proposal would still double the number of families who pay the AMT, from 4 million to 8.4 million, and double the AMT's

³In 2006, the IRS reports that two-thirds of the total income taxed at 25 percent was earned by taxpayers whose highest tax bracket exceeded 25 percent.

⁴This \$45.1 billion does not include the cost of the AMT patch Congress is likely to enact (\$70 billion or so).

revenue as well. If the AMT is further patched to deal with this problem, then the cost of the McConnell proposal would jump to \$77 billion a year — six times the no-AMT-patch cost!⁵

Senator McConnell and his allies (including President George W. Bush) have a history of using the AMT to reduce the projected cost of their proposed tax breaks. For example, the first Bush tax cut did not include a reform of the AMT, so budget forecasters had to assume that the AMT would “take back” a large portion of the Bush tax cuts. Since then, President Bush and congressional Republicans have repeatedly claimed that their intentional expansion of the AMT was totally “unintended” and that the AMT must be slashed or even abolished without replacing the substantial lost revenue. Political circumstances may have changed dramatically recently, but some lawmakers seem to be playing the same old game.

3. So who would get the tax cuts under from Senator McConnell's plan?

It's hard to analyze the effects of Senator McConnell's tax proposal without knowing what will happen to the AMT. Or put another way, a \$13 billion tax cut is a lot different from a \$45 billion tax cut, not to mention a \$77 billion tax cut.

One thing is very clear, however. To analyze Senator McConnell's plan under the assumption that there will be no AMT relief in 2009 would be extremely misleading. So in the table that follows, we show the distributional effects of McConnell's proposal assuming a traditional AMT patch, i.e., the \$45 billion version of his plan. Under this scenario, over three-quarters of McConnell's tax cuts would go to the best-off fifth of all taxpayers.

In presenting this table, we recognize that Congress may be reluctant to let the number of people affected by the AMT more than double. So we caution our readers that the true impact of the McConnell plan may be even more tilted toward well-off taxpayers.

McConnell Proposal: Reduce 25% Income Tax Rate to 15%				
(assuming that Congress adjusts the AMT as it has in previous years)				
Income Group	Total Tax Cut (\$Billions)	Average Tax Cut (Dollars)	Share of Total Tax Cut	% with tax cut
Lowest 20%	\$ —	\$ —	—	—
Second 20%	—	—	—	—
Middle 20%	-0.6	-22	1.4%	7%
Fourth 20%	-9.8	-345	21.8%	24%
Next 15%	-25.4	-1,189	56.5%	55%
Next 4%	-6.6	-1,150	14.6%	47%
Top 1%	-2.6	-1,820	5.8%	33%
ALL	\$ -45.1	\$ -311	100.0%	16%
Addendum:				
Bottom 60%	-0.6	-7	1.4%	2%
Top 20%	-34.6	-1,212	76.8%	52%

Source: ITEP Microsimulation Model, January 2009

⁵This \$77 billion cost figure is in addition to the \$70 billion or so that a traditional AMT patch would cost.

4. Would the McConnell plan be an efficient economic stimulus?

The preceding table shows that the middle fifth of taxpayers would receive just 1.4 percent of the benefits of McConnell's proposal in 2009, assuming an AMT patch similar to previous ones (but not one big enough to avoid doubling the number of people paying the AMT). Thus, although it would seem that anything billed as a "middle-class tax cut" ought to be directed to people in the middle of the income scale, that's not the case with McConnell's plan. Even the wealthiest one percent would get a larger share of his proposed tax cut than the middle 20 percent. The average tax cut from his proposal would be \$1,820 for the top one percent of taxpayers in 2009 but just \$22 for taxpayers in the middle 20 percent. (The poorest 40 percent of taxpayers would receive no benefit, since none of them are in the 25 percent tax bracket.)

Low- and middle-income families likely need the most help during this downturn. But even putting aside the moral problems with directing tax cuts predominantly to the well-off, there are economic reasons for Congress to reject this proposal.

Logic suggests, and most economists think, that the purpose of a "stimulus" package is to stimulate demand, either by direct government outlays or by giving money to people who are likely to spend it right away. It's also well-known that better-off people tend to save and invest a large portion of their money, while low- and middle-income people tend to spend most of their money.

Tax cuts of any kind may not be the most efficient way to stimulate the economy compared to other options. But tax cuts targeted to low- and middle-income people at least have a decent chance of being immediately pumped into the economy. By instead targeting his tax cuts to better-off people, McConnell has designed a plan that would fail to provide much stimulus bang for the bucks he wants to expend.